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Reflections on the key economic questions in the Scottish Independence Referendum

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Abstract

This paper reflects on the key economic questions of the Scottish Independence Referendum that should continue to be a political priority and sit at the heart of the debate. It poses the critical issues upon which the political leaderships should focus and provide greater insight and clarity into their thinking. These central questions range from the fundamental nature of economic self-determination to the high-profile and, arguably, primary economic choice of which currency system a newly independent Scotland would wish to adopt. It also focuses on the meaning of *independence* and *dependence*, and on the choices and trade-offs that must be faced. It finally draws out the importance of viewing the Referendum as an irreversible process and the need to assess *all* the constitutional propositions in a systematic manner with a particular emphasis upon their long term value.

I Introduction.

In the early days of the Scottish Independence Referendum debate, many commentators argued that the poor quality of the exchanges was, in part, due to the paucity of the underlying analysis of the constitutional alternatives and the possible economic systems that might be adopted. Over recent months, this picture has changed and a wide range of thinking has now been published to inform the debate². The valuable articles that appeared in this Commentary in March 2014³ were one such contribution. The constitutional models founded on political independence have, quite appropriately, received considerable attention. In contrast, the alternative options of enhanced evolution within the UK⁴ have so far been poorly articulated, largely due to the weakness of the underlying thinking and analysis.

Naturally, some contributions have had explicitly political origins and, given the realities of political debate, were bound to reach predictable conclusions that supported the author's cause. It would, however, be a mistake to discard these pieces since most, nonetheless, contain helpful insights into the primary issues. Other contributors have had more objective origins and, as such, their work has taken on a greater standing. In general, the political challenge is to now make a more productive and considered use of all these contributions, particularly the latter.

In essence, it can be argued that the principal questions that should be confronted in the Referendum debate have now been identified, but there have been few areas of convergence between the protagonists. Unsurprisingly, the intensity of the interaction in the present political context and the

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² Some of these valuable contributions are referenced at the end of this paper.

³ Fraser of Allander Economic Commentary, Volume 37(3), March 2014, Fraser of Allander Institute, University of Strathclyde.

⁴ These are summarily set out in chapter 1 of Goudie (2013).

extensive uncertainty about many key parameters in the post-Referendum world necessarily make such convergence highly unlikely.

The reflections in this paper^{5,6} are therefore focused on the key economic questions that, arguably, should continue to sit at the heart of the debate over the remainder of the campaign and which, notwithstanding the earlier comments, still deserve to be a political priority. Much has been said and written by the political leaderships⁷ over the past year, but rarely with a sharp focus on these questions *and* on rigorously argued explanations that would provide greater insight into these challenges. In the absence of this clarity, it appears that an otherwise confused electorate will find great difficulty in assessing the constitutional alternatives currently on offer.

II **The key economic questions.**

In some key respects, the debate has clearly moved on. Whether for perceived political expediency and political advantage or on account of the economic and financial evidence, few now contest the capacity of an independent Scotland to be sustainable and indeed succeed in the global economy. The issue now is focussed much more sharply on *how* successful it would be over the long term – and, particularly, in comparison to the continuance of Scotland within the UK – and on *how* smooth would be the transition to a sustainable state and with what interim costs? Even those who have serious reservations about the economic prosperity that might ensue from an independent Scotland are careful to avoid the political minefield of seeming to suggest that Scots are not competent to run their own affairs or are trapped in a state of dependency with the UK that cannot be broken.

There are a set of key economic questions that remain fundamental to the debate:

1. ***The Fundamental Political Economy Perspective.*** Underlying the basic constitutional question faced by the people of Scotland lies a critical choice: is the pre-eminent issue...

under which constitutional arrangement, whether based on enhanced powers within the UK or on political independence, will I be economically better off?

... or, is it ...

irrespective of my precise future economic circumstances, do I wish national self-determination – albeit one that will be constrained in significant ways by the reality of the global economy, and by any monetary union that we may enter - to drive my economic future?

The political prominence accorded to one or other of these key questions is clearly shaped by the strategic approach of the two campaigns and by where they feel the greatest political advantage might be gained. In part, this is driven by what the available evidence might be suggesting and whether it appears to favour or challenge a specific constitutional preference. Equally, the apparent lack of robust

⁵ Many of the detailed economic questions in the debate are analysed in considerable detail in 'Scotland's Future: the economics of constitutional change', Andrew Goudie (2013). This is a compilation of papers from the outstanding experts in the economic fields most relevant to Scotland's constitutional debate.

⁶ Some sections of this paper reproduce material first set out in *The Geographer*, published by the Royal Scottish Geographical Society (April 2014).

⁷ There are many examples: the key pro-independence document is *Scotland's Future : Your Guide to an Independent Scotland*, Scottish Government (2013); the primary pro-union documents may be found on the UK Government website referred to in the References at the end of this paper and, also, for example, in Darling (2013).

and high-quality evidence and the dominance of risk and uncertainty are also strong motivators of the political preference for emphasizing one or other of these.

Survey work⁸ has suggested that the electorate does, indeed, see the economy as the key issue. Voters would apparently be significantly more likely to support a politically independent Scotland if they were £500 better off than if they were £500 worse off⁹. Interestingly, therefore, this tends to suggest that economic self-determination – rooted in a sense of national identity and nationhood - is less important than certain economic benefit. However, herein lies the paradox: while people may wish to see the economy – and, notably, their personal economic benefit – as the critical and decisive determinant of the outcome of the Referendum, it is an area of inevitable uncertainty and indeed speculation, as we consider further below. The knowledge base is simply too weak to provide the clarity that allows this to be the central issue upon which the electorate can form a considered and informed judgement. At the macroeconomic level, there is no convincing evidence of the relative benefit to economic growth of the two differing constitutional arrangements currently before the electorate. Indeed, there are similar weaknesses in assessing the net impact – and thus credibility - of particular policy promises or the priorities of individual governments and political parties, whether in areas as diverse as income tax, corporation tax, specific welfare programmes or particular universal benefits.

So, how is this paradox to be resolved? If people feel that their major concern is going unanswered – whether because it is unanswerable at this time or because the answers are riddled with apparent contradiction, confusion and complexity that leaves them none the wiser – the issue will be: *what then drives people's thinking instead?* Will people adopt a broader understanding of their likely economic net benefit that, for example, encompasses the benefits from the public services that they enjoy or the benefit they derive from the potential gains in their environmental and equity perspectives?

The fundamental vision and generosity of the welfare system has been a prominent issue in this regard, with the argument hinging on the nature of the underlying values of Scottish society. Indeed, it highlights a key question in the debate: *are fundamental Scottish values substantively distinct in a wide range of areas of economic, social and environmental life from those prevailing across the UK as a whole and, if they are, have they been sustained – and appear likely to remain sustained – over many decades?* If they are shown to be such, then the case for greater self-determination and powers and, *in extremis*, political independence, is significantly more compelling. The European elections of May 2014 and, specifically, the political response to the apparent – and now realized – attraction of UKIP to the UK electorate has provided a further clear example of this point. Is Scotland fundamentally – both in the sense of the view being dominant across society and held consistently over the long term - distinct from the rest of the UK in its attitudes to both immigration and to political and economic union with the EU?

Three additional points are important here. Firstly, it is worth noting that the motivation of economic self-determination is relevant to the options founded on both independence and enhanced devolution, although clearly to differing degrees and probably with differing degrees of future reversibility or refinement. Secondly, the “£500 debate”, while dismissed by many as absurdly simplistic and superficial

⁸ The Social Attitudes Survey (January 2014) provides considerable insight into the thinking of the Scottish people with respect to constitutional change. See Curtice (2014).

⁹ The Social Attitudes Survey suggested that, in the former eventuality, 52% would support political independence while, in the latter case, only 15% would support independence.

in a debate of such immense importance, does at least throw the limelight onto an outcomes perspective, albeit one that is extremely limited. Ultimately, the economic value of constitutional change is about the potential impact on the outcomes that determine the lives and well-being of the people of Scotland and, some would argue, of all the people of the UK and indeed the wider global community.

And, finally, it is worth noting that, if people are indeed motivated by personal economic outcomes, then, while the technical debate may seem dry and obscure, it is, nonetheless, pivotal.

2. ***The Choice of Fundamental Economic System.*** Recent months have revealed an emerging consensus that Scotland's currency choice is the key challenge. This single decision has such far-reaching ramifications for the definition of the entire economic system that, while a careful analysis of the individual policies that each currency choice might permit or necessitate is important, ultimately, we must revert to the most basic and, arguably, the first decision that should be determined: the currency question. In essence, the crux is: *firstly, which currency system would best facilitate the attainment of society's primary objectives and, secondly, which constitutional arrangement would facilitate the currency system that Scotland would therefore prefer?*

There are, of course, other key dimensions critical to the definition of the economic system – as, for example, with the fundamental choice of the basic level of public sector expenditure, relative to its output, that the nation wishes to establish – but the focus here is upon the currency question.

Formal sterling currency union. The striking interventions with regard to the prospects for a formal sterling currency area by the UK Chancellor, other senior pro-union politicians and the Scottish First Minister in February 2014¹⁰, and the subsequent furore that they sparked, demonstrated the centrality of the currency question. The apparently unambiguous declaration by the pro-union leaders that an independent Scotland would not be able to formally adopt sterling invites many critical questions. If this position is seen as credible and an irreversible UK policy stance, then the advocates of independence necessarily will be under immense pressure to define a new currency position that they can - or, more probably can - deliver. If this pro-union position is seen as unsustainable and reversible, not least in the face of an actual decision by the people of Scotland to support independence, then little has changed. It will be the post-Referendum negotiations that are crucial.

The Osborne *et al* intervention has been portrayed by the pro-independence campaign as typical of heavy-handed Westminster pro-unionists, and by the pro-union campaign as a necessary contribution to the debate to inform the Scottish people of the post-Referendum reality if the vote were to back independence. Perhaps, most importantly here will be the popular mood across the rest of the UK in the event of a vote for Scottish independence. If UK public opinion were hostile to Scotland remaining within a formal currency union, then the issue will turn on whether the UK Government at that time – assuming it was indeed prepared, in principle, to reverse its current position in the cold light of day following the vote, which is, of course, inevitably uncertain – was willing to go against the prevailing popular mood in the remaining UK. This is potentially a far more serious challenge for a newly independent Scotland wishing to set up a formal sterling area. How this popular view evolves will be

¹⁰ See HMT (2014) and, for example, the BBC (2014a). In addition, the intervention of the HMT Permanent Secretary added further to the heat of the exchanges that followed (see HMT (2014)).

key and will no doubt reflect the closeness of the vote, the underlying attitudes towards Scotland, the perceptions of the costs and benefits of Scotland to the rest of the UK and the atmosphere created by the political classes and media at the time.

The popular mood and the consequent stance of the UK parties post-Referendum will be brought all the more sharply into focus in the light of the imminent UK elections in May 2015. It is highly probable that all the UK parties will be obliged to be explicit in their manifestos about their proposed stance in the post-Referendum negotiations in the event of a pro-independence vote. Reflecting the popular view will therefore be a crucial element.

However, there are deeper issues at stake here. For example, even if the current UK Government's position is indeed final and an informal sterling area emerged, there is still the key question of whether global financial markets would find this a long term, credible situation, or would they behave as if the informal arrangement were in fact quasi-formal. In the event of a financial crisis in Scotland¹¹, for instance, would the rest of the UK - in an informal sterling union - stand aside and not provide support, even when there was a UK self-interest in a stable currency union? In other words, from a UK perspective, what risks would be generated by Scottish participation in an informal union? Given that the Scottish economy constitutes almost 10% of the present UK economy, a share significantly in excess of the size of Hong Kong or Panama relative to the Dollar zone, would the UK not wish, in reality, to have an up-front agreement that provided some *ex ante* reassurance about the conduct of Scottish policy?

Moreover, from a Scottish perspective, just how different would an informal sterling zone be from a formal sterling monetary union? Some argue that Scotland would *de facto* be equally subject to the UK's monetary policy under either scenario.

Interestingly, while the UK self-interest in a continuing sterling monetary union, that included an independent Scotland, has been strongly asserted as a clear reason for the UK agreeing to such a formal union, the case has been advanced primarily on the basis of the increase in transaction costs¹² that would be imposed on UK businesses, consumers and visitors were Scotland compelled to adopt a non-sterling currency. Important though transaction costs would undoubtedly be¹³, this consideration is dwarfed by the far greater concerns regarding the fundamental stability of the sterling union and the costs that might be incurred were the union to prove unsustainable and unstable. It is here that the UK pro-union advocates see the greatest threat to the UK interest. Events in the EU since 2009 have only served to heighten these fears.

Similarly, the UK dependence on the strength of Scottish trade and exports – and, especially, Scottish North Sea oil assets - has often been cited as an important factor in the UK interest. This analysis begs

¹¹ It is important to acknowledge in this context that it is highly unlikely that the structure of the Scottish economy would remain unchanged through a period of major transformation to independence as, for example, corporate decision-makers reassess their operations and investment decisions in the light of a new economic environment with its different set of incentives and risks. Thus, the nature of a future financial crisis, for example, is likely to be quite different from the one of 2008 and the claims on Government would similarly be expected to be substantively different, too.

¹² See, for example, BBC (2014b) or New Statesman (2014).

¹³ In view of Scotland's greater dependence on trade with the rest of the UK, these costs are likely to impact proportionately more on Scottish interests than on the rest of the UK's interests.

the question of who actually owns the North Sea assets that are being exploited and who benefits from the profits¹⁴: to where is the profit directed..... to within Scotland, the UK, the USA or elsewhere? And, moreover, would the North Sea assets be actually traded in sterling? It is also interesting to consider that, while there may be monetary policy arguments for a strong currency, few economies in practice are unhappy to see their competitiveness enhanced through modest depreciation. Indeed, many have argued that, if the benefits of the North Sea were to accrue primarily to Scotland, the UK would not be averse to seeing its currency weaken to facilitate the development of other tradable sectors. The UK interest here is therefore not clear-cut.

On the other hand, it has been argued forcefully by some throughout the Referendum campaign that the currently constituted UK is the best global example of a successful optimal currency area, that has developed over the centuries to become a very highly integrated and prosperous economic zone. It would seem inconsistent, therefore, for the UK to rush to dismantle such an effective currency union if, indeed, a stable union could be agreeably established to the mutual benefit of both economies, difficult though that might prove to be.

The refusal of the pro-independence camp to countenance anything other than a formal sterling area, largely for fear of opening up an area of debate that would expose it to considerable challenge about the feasibility and value of the alternatives, which it would not welcome, is both striking and critical to the Referendum. Similarly, the blunt rejection of a formal sterling union by the pro-union camp in its effort to starkly expose the massive risks, as they see it, from independence, has had an equivalent effect.

Both stances have effectively killed the prospect for further meaningful debate of the alternative options. The *apparent* choice before the electorate is a simple one: either sterling within the political union or sterling with independence, formally agreed and negotiated with the UK Government. In this regard, the pro-independence camp has been relatively successful. Whether the present stance of the three pro-union leaders is a bluff or not, the pro-independence camp has – so far – avoided a highly problematic debate about alternative currency plans, one which would raise very significant questions of future risk and uncertainty. In contrast, the pro-union camp has not, to date, dispelled the view that a formal currency union is, in fact, possible and that the more extreme risks of independence are therefore avoidable.

What would seem almost certain is that, post-Referendum, were there to be a majority in favour of independence, there *would* be negotiations between the new Scottish administration and the UK administration about the future currency and any transitional process. It would seem inconceivable that, given the present, deeply-embedded role of sterling across the UK, a future UK Government could refuse to at least discuss the conditions under which a formal sterling area *would* be acceptable to them.

That these conditions might ultimately prove unacceptable to Scotland is a different, though critical, point.

¹⁴ This issue has recently emerged in the wider discussion about the underlying wealth of the Scottish economy in the light of the high levels of overseas ownership of businesses in many of Scotland's key sectors, such as oil and gas, financial services and whisky.

The nature of the UK's preferences with respect to such conditionality are considered further, later in this paper, but the key point is to identify the perceived risks about which the UK would be most concerned and understand the form that its conditions might indeed take. The UK interest would primarily appear to focus on the regulation and control of the banking system and the tightness and discipline embedded in a set of fiscal rules that shaped fiscal policy at both the aggregate and detailed policy level. If conditionality could be designed in such a way that it *were* deemed appropriate by a UK administration, why would the UK then reject a formal agreement, not least since the UK would no doubt see benefits to itself from, for example, averting the prospect of an independent Scotland adopting a more competitive exchange rate or tax regime, or contributing less than proportionately (in UK eyes) to its continuing adjustment programme and to the unravelling of the quantitative easing programmes¹⁵?

At present, the political context is dominated by the apparent rejection by the pro-union parties of a formal sterling currency union. Paradoxically, if negotiations were to take place following a *yes* vote, then it is easy to see that it might be the newly-independent Scottish administration that rejects a formal currency union.

It also would seem obvious that, if establishing a formal sterling area proves impossible because the two governments are unable to converge on a workable agreement, the pro-independence camp would be prepared for an alternative currency arrangement. While preparations now might not be conducted openly, it would be extraordinary if the Scottish Government were not already thinking about and preparing for this potential outcome. Failure to do so would risk either a further period of damaging uncertainty or an ill-thought out leap to an alternative without the necessary preparation.

Informal currency union. The other currency options have not generated any extensive exchange, especially at the political level. To most, it appears that it is self-evident that both a new Scottish currency – whether free floating or pegged to another currency, such as sterling - and membership of the euro area are indisputably second best choices. Either the economic or political risks, or both, are overwhelming.

One exception to this constrained currency debate has been the recent discussion, led by John Kay¹⁶, around Scottish participation within an *informal* sterling area. In principle, such a system could be operated and, as he notes, in the present global economy, business already transacts in any currency of its choosing. There is, nonetheless, “*no precedent for an advanced country with a sophisticated financial system choosing voluntarily but unilaterally to share another country's money*”.

The pros and cons of an informal currency union are well demonstrated in other economies that have adopted such a system. Foremost, Scotland would not have control or influence over UK monetary policy, but many have argued that this is the case even within a formal currency union, as far as a much more junior partner is concerned. Similarly, others have pointed to the absence of the lender of last

¹⁵ See Scottish Government (2014) on the latter point here.

¹⁶ See, for example, John Kay's article: *English Law cannot stop Scots being sterling squatters*, *Financial Times*, April 8, 2014.

resort role of the Bank of England as too big a price for informal union. However, as has been pointed out elsewhere¹⁷, the lender of last resort role has not been fully understood in the Referendum debate. Such a role certainly does have benefits in some circumstances of financial stress, but responsibility for failed financial institutions does *not* fall solely on the host nation, as many commentators seem to assume without question: where the bulk of the operations of a failing Scottish bank were to lie in other economies and other jurisdictions, it is those nations that would bear the majority of the burden of resolution¹⁸. Certainly, an independent Scotland would have responsibility to guarantee Scottish depositors, but this would not extend to the unilateral and unlimited bail out of every Scottish financial institution.

Importantly, the informal use of sterling overcomes one big challenge compared to the option of adopting a pegged or a floating exchange rate: namely, there is a smaller challenge in establishing the permanence of the currency arrangement and the credibility of the set rate, unless, of course, the informal union is, itself, seen as temporary. With an informal union, short term speculation would be expected to be minimal, *providing* it is indeed seen to be credible and there is thus a minimal risk of capital flight.

The pegged currency option. Interestingly, the pegged currency option probably deserves more attention, not least for an eventuality in which a formal sterling union option might indeed be ruled out either by the UK Government or by a newly independent Scotland were the conditions demanded by a UK Government to be deemed economically or politically too restrictive and one-sided.

A pegged currency has several potential attributes that might make it attractive. Superficially, there might be seen to be significant political mileage in a newly independent nation having its own currency. More substantively, Scotland having its own currency might be seen over the longer term as paving the way both politically and economically for a move towards adopting the euro, once the latter had been placed on a far more sustainable footing. On Day 1, an independent Scotland would be expected to continue within the existing currency union, but a decision to adopt a pegged exchange rate in due course would precipitate a process to establish the necessary economic and financial institutions. These institutions would, moreover, provide a significant long term advantage, as, were any subsequent decision in future years taken to abandon the peg for any reason, the institutional framework would already be in place and have proved its operational capacity.

¹⁷ See, for example, section 1.3.2.2 of Goudie (2013) that covers this point in greater detail. For more detail, see Professor John Kay's contribution in *Evidence to the Inquiry on The Economic Implications for the UK of Scottish Independence*, The House of Lords, Select Committee on Economic Affairs, 22 May 2012; or his *Evidence to The House of Commons, Scottish Affairs Committee*, 14 March 2012.

¹⁸ Again, see Goudie (2013) for some clear indications of how this mechanism operated during the 2008-09 financial crisis in both the USA and the UK. In addition, in his *Evidence to the House of Lords Select Committee on Economic Affairs* in its *Inquiry on The Economic Implications for the United Kingdom of Scottish Independence*, in November 2012, Sir Philip Hampton noted that in "late 2008, because we have substantial operations in the United States, we used the US Federal Reserve as a lender of last resort, providing short-term liquidity when the market completely dried up. That was because we had a US banking licence and we were operating in the United States. A central bank does not want its banking system to collapse, so it acts for all the banks that are operating in that country. We have used many central banks as a lender of last resort for the many operations that we have in the many jurisdictions in which we operate. That is a key part of what central banks do in the jurisdictions that they control." The research of Bloomberg (2012) is also highly relevant here.

From the UK's perspective, there are also clear advantages which would go some way to alleviate the present concerns that have apparently motivated the decision to rule out a formal sterling area. Namely, with a peg, there would be a major transference of risk from the UK to Scotland. The UK would be expected to support a peg against speculative activity but not against any fundamental disequilibrium that it perceived. Moreover, to the extent that sustained speculation might itself induce a more permanent disequilibrium, the UK authorities would be expected to limit their support in this eventuality. The UK could therefore walk away from a peg at any time, leaving the primary risks with Scotland. Unlike the formal sterling area option, therefore, where the UK perceives the risk to still reside with itself, that risk is largely eliminated with a peg. There is thus a major incentive for Scottish policy to be designed to satisfy the international financial markets if Scotland wishes the peg to operate in a stable and sustainable manner.

On the other hand, a pegged currency may be seen as a quasi-monetary union, with all that that implies for monetary and fiscal policy: it shares many attributes of an informal sterling area, albeit one that is based on two pegged currencies. In addition, the obvious disadvantage that is embedded in this model is, of course, that the stability of the peg critically depends on the credibility of Scotland's monetary and fiscal policies and a strong underlying belief in the absolute sustainability of the peg and the established rate. As was seen within the euro zone in 2012, even with a single currency relatively well established, any suggestion that the Drachma might be re-established was sufficient to precipitate the markets to adopt immediate risk mitigation – typically entailing major currency in/outflows – with immensely damaging implications and self-fulfilling expectations. The expectations in Greece's case were only thwarted by the weight of potential German support: a clear distinction from the context in which any peg would operate between Scotland and the UK.

Few economists appear to dissent from the view that Scotland and the rest of the UK together form a very good approximation to an optimal currency area¹⁹. Moreover, a change of constitutional state would not be anticipated to change that view in the foreseeable future, even if, over the long term, this might be less clear. Consequently, it can be argued from this perspective that the heart of the currency debate should be about the conditions that would – or could – create sustainability and mutual benefit within a common currency area, not about second-level concerns and not drowned under the noise of political manoeuvring. It could be argued that – with appropriately designed institutions, mutually acceptable directives on the operation of key policies, appropriate risk sharing and oversight, and the pooling of sovereignty, amongst other key elements – a mutually beneficial currency union might be constructed. As was noted above, the key point is whether or not the terms of such an arrangement would be agreeable to all parties and whether or not it would be preferable to having no agreement.

Understanding the alternative currency options²⁰ that might need to be pursued for any of the reasons outlined above would seem a prudent step for both parties in entering a transitional stage of preparation for independence. The political reality is that this will, however, simply not happen openly pre-

¹⁹ See, for example, chapter 1 in Goudie (2013) for a summary of the underlying theory and conditions conventionally seen as bearing most directly on the definition of an optimal currency area.

²⁰ The work of Ronnie MacDonald is also highly relevant here as, for example, in MacDonald (2013) and MacDonald (2014). His basic thesis is that a sterling currency union may not be sustainable if, as the advocates of independence suggest, an independent Scotland did indeed, in time, have a relatively superior productivity record compared to the rest of the UK: a flexible exchange rate regime would then be necessary in this circumstance.

Referendum. The prospective cost to both the pro-union and pro-independence camps of negotiating on their current currency stances would appear immense: further meaningful debate of the alternatives would thus appear politically inconceivable at present.

3. **The Nature of Independence.** Inherent in this third key question is the heart of the constitutional debate: *to what extent does political independence facilitate meaningful and substantive economic independence?; and are currency union options necessarily constrained, since both monetary and fiscal policy are inevitably limited by the conditions imposed on the union by the members of that union?* The recent intervention by the Governor the Bank of England²¹, though carefully crafted to avoid overt political comment, was nonetheless insightful in demonstrating his view that the effective and sustainable working of a monetary union necessitates a high degree of coordination and collaboration. He argued for a relatively sophisticated pre-determination of the rules that would shape behaviour within the union and, importantly, a high degree of risk-sharing and risk-pooling within the union²², with all that that implies for the sovereignty of the two states. In the present political climate, it is difficult to see UK Ministers rejecting the Governor's perspective.

It would seem inevitable that any formal monetary union would entail a complex negotiation in which the nature of the conditionality, imposed on each other by the membership, was determined. In this circumstance, the relative power and influencing capacity of the partners to the monetary union are central to the strategic and policy outcomes that emerge. In general, as other such unions have demonstrated, the most powerful economic participants yield by far the greatest influence. Thus, the independence of the smaller interests is certainly likely to be circumscribed. The key question in the event of a pro-independence vote, in which a formal sterling monetary union is the preferred option, is therefore: *are the perceived benefits of the monetary union sufficiently great as to outweigh the perceived constraints and conditionality of the union, or, is the newly gained political independence seen to be too heavily compromised - and the proposed conditionality deemed both politically and economically unacceptable - such that an alternative option is preferred?*

4. **Choices and Trade Offs.** One element of the constitutional challenge that has been largely lost in the political exchanges to date has been the simple observation that no single constitutional option provides an unambiguously better opportunity. All options entail choices and trade-offs.

²¹ Bank of England (2014).

²² The type of agreed framework that has been advocated embraces critical areas of economic and financial policy, such as:

- A banking union, encompassing a common regulatory framework for the financial sector, common procedures for resolution, a pooled system of deposit insurance and guarantee, the necessary facilities for the Central Bank to act as lender of last resort, and structures and regulations that enabled the decoupling of the banking system from the sovereign, deemed necessary for times of financial crisis;
- Some form of fiscal facility with substantial resources to facilitate fiscal risk-sharing, the implementation of stabilisation policy, including the key automatic stabilisers, and an equalisation role;
- A shared fiscal arrangement, embracing a set of agreed fiscal rules to provide reassurance to all the parties that would bear risk within the union;
- Monetary policy union, including interest rate policy and any monetary easing policy, These would be set by the Bank of England, according to a remit provide by the UK Parliament.

Continuance of the union necessarily implies that some policy decisions taken in Westminster will be less directly appropriate for Scotland: quite obviously, one-size-doesn't-always-fit-all perfectly. If UK interest rates rise rapidly in the coming couple of years to counter a housing boom that is concentrated in the South East, then this clearly is not *directly* promoting recovery in a Scotland with a much softer housing market. However, whether the overall net benefit of full autonomy (which may, for example, bring with it a greater vulnerability to external shocks) exceeds the overall net benefit to Scotland of being within the UK (without – in this example – the autonomy to set its own interest rates) is the key point. This is a complex issue to resolve as demonstrated in this example which illustrates an asymmetric shock to the UK. There are two key questions here: firstly, what degree of interest policy autonomy would an independent Scotland, in fact, have²³ and, secondly, equally, to what degree would the union, in reality, protect Scotland from external shocks.

Similarly, as a second example, it would seem unwise to fight the apparent reality that Scottish oil production is set to fall, as new investment slows the rate of decline but does not arrest it, and that an independent Scotland is, therefore, likely to be more vulnerable on this count than being within the UK. This apparent fact is, however, constitutionally neutral: it is not itself sufficient to undermine independence. It should prompt a vigorous debate about how, with independence, both the declining contribution of oil might be managed and how this might be mitigated and at what cost this might be done. These are the insights that should inform the debate since managing this inevitable set of risks is the key issue, not the decline in oil production *per se*. In essence, there is a key choice to be made with respect to the autonomy (with perhaps greater vulnerability) versus risk-pooling and risk-sharing (with fewer degrees of economic self-determination) trade-off.

The general concern here should be that the assessment of the constitutional choices has been dogged by piecemeal and partial analysis that has failed to capture the economic reality. Of course, a lower Scottish corporate tax rate, *cet par*, is likely to benefit Scotland²⁴. Of course, retaining the disproportionately high flows of research resources from the UK Government to Scotland is a major benefit to Scotland. But just as the former cannot, in isolation, make the case for an independent Scotland, so the latter does not, in isolation, make the case for the union.

The most prominent and critical macroeconomic decision about the currency choice makes the point equally strikingly. The UK rejection of a formal sterling monetary union rests heavily in the argument that an economic system will not be stable if it embraces a monetary and banking union, but not a fiscal union. Some argue, of course, that it requires a political union. The Governor of the Bank of England and the European Union appear to broadly share this belief. If stability does, in fact, necessitate this complex set of unions, then an independent Scotland faces a stark choice between a relatively highly constrained independence within a formal union or adopting its own currency. There would be no real-world option of currency union with an unconstrained fiscal policy, for example. Certainly, the aggregate fiscal stance within a currency union would appear very likely to be constrained but, similarly, it is not improbable that the detail of fiscal policy may be limited, not least with concerns over tax competition and the like. Of course, the existence of this trade-off would be contested by some. They would argue that

²³ Clearly, there is no monetary policy autonomy in the case of a monetary union.

²⁴ Darby et al (2014), *Natural Geography, Firm Location and the Corporation Tax Debate*, Fraser of Allander Economic Commentary Vol 38, (1), June 2014.

fiscal autonomy within a currency union is indeed possible and would be their intended arrangement. Only post-Referendum negotiations will resolve the degree to which this trade-off exists but the indications are that it will not be an uncontested area of debate at that time.

Ultimately, these examples beg the same critical question of what the totality of any constitutional proposition might look like: is one single preferred policy worth having, given the other costs - and benefits - that would necessarily be part of the proposition? In other words, what policy configurations are, in fact, possible?

Importantly, these questions pose the same critical challenge to both the pro-union and the pro-independence models of constitutional change.

In a similar vein, there are equally critical trade-offs, that are imposed in reality for every constitutional model, which derive from the unavoidable limitations on resources. Given finite resources, including the capacity to sustainably borrow, the application of powers that entail significant expenditure will ultimately be constrained. As with policy configurations, so expenditure configurations therefore need to be seen in their totality - including what configurations are possible and which are most effective in meeting the stated objectives - and in their detail - again, which specific policies are feasible and most effective.

Precisely defining the net benefit of any constitutional proposition is, of course, totally unrealistic: identifying and aggregating the benefits and costs of any proposition is simply impossible. This fact should not, however, lead to the rejection of the critical *qualitative* point: we need to understand the *feasible* policy packages that define any constitutional proposition and the likely net value of each of these policy configurations.

5. ***The Lessons from Europe.*** Directly relevant to many of the previous points is the question: *what have we learned from the traumatic experience of the European Monetary Union over the course of the financial crisis and subsequent protracted recession?*

Certainly, there have been indications of an emerging consensus - whether we like it or not - of a clear need to establish greater economic coordination and collaboration through banking and financial sector unions and through fiscal union, as was echoed in the Governor of the Bank of England's recent comments. *Are these apparent lessons directly applicable to a possible sterling monetary union?* And what do we also learn from the experience over recent times of other small independent European economies that have successfully maintained stable economic systems outwith the EMU and, indeed, outwith the EU? There is much in these questions to understand still.

6. ***Is there a status quo option?*** One little-discussed question has been whether the *status quo* is in fact an option at all? The Scotland Act (2012) moves Scotland on from the original 1999 devolution settlement, but it would, for example, appear extremely unlikely that a UK Government would not revisit at least two critical elements post-Referendum following a *no* vote: firstly, the basic UK equalisation question and, secondly, the range of powers that Scotland might assume in addition to those defined in the 2012 Act.

The Chief Secretary to the Treasury has recently claimed²⁵ that, since no pro-union party is advocating any revision to the Barnett formula, he can reassure the electorate that it will not be amended. This appears to contradict the Liberal Democrat 2010 manifesto²⁶. As ever, there is therefore the question of how credible is such a claim in the face of the known opposition from some political groupings and in other parts of the UK. A less likely interpretation of his comments might suggest the continuing use of Barnett - or a broadly similar mechanism - to make annual revisions to the funding flows, while looking again at the underlying Needs Approach and the base to which Barnett is applied. In many ways, this seems a more probable way forward and, therefore, makes current claims of a *status quo* in this regard questionable.

Ultimately, the question is: *is the current approach (founded on a considerably dated, underlying Needs Approach to equalisation and the marginal adjustments determined through the Barnett formula) sustainable or will the pressures for revision be overwhelming?* Any revision would be a very significant step away from the *status quo*.

In addition, as is considered in the subsequent paper in this Commentary (*Reflections on the pro-independence and pro-union contributions to the Fraser Economic Commentary and on the proposals for enhanced devolution of economic powers to Scotland*), such is the public support for enhanced devolution – and the momentum behind the proposals of the three main UK Parties - that it seems improbable that, were independence to be rejected, more powers would not be granted to Scotland. Moreover, it would be anticipated that the greater the degree of enhanced devolution that is adopted, the greater the likely strain on the existing Barnett arrangement and the more likely it is, therefore, to be reviewed in a more substantive manner.

7. Irreversibility: Assessing the Long Term Value of the Constitutional Propositions. To date, the debate has been somewhat casual about what is really of direct interest to a constitutional question for which the outcome is presumably a new arrangement that could span decades, if not centuries. Arguably, it is not the capacity of a new arrangement to handle the big current economic policy challenges, but rather the capacity to respond to the challenges that might be anticipated over the very long term and, indeed, the challenges whose nature and import is absolutely speculative. The central challenge is: *would the new economic system, that is enabled by new powers, display the characteristics that we would require to promote a stable and sustainable economy in the face of the huge global challenges that might be encountered over the coming decades?*

Six Tests were set out in Goudie (2013), which seeks to focus attention on the major economic questions that a new political system – and the economic systems that could be designed within that new politics – ought to be able to handle, with a particular emphasis on the longer term²⁷.

²⁵ At the Launch of the UK Government document, *12 things that a £1400 UK dividend could buy*, May 2014.

²⁶ Here, it states that the Liberal Democrat Party would “.....replace the current Barnett formula for allocating funds to the Scottish, Welsh and Northern Irish governments with a new needs-based formula, to be agreed by a Finance Commission of the Nations”, *Scottish Liberal Democrats Manifesto*, 2010.

²⁷ Goudie (2013): see chapter 2. The subject-specific chapters – all written by highly distinguished experts in their field – provide a similar insight: each concludes with an explicit statement of the critical questions that must be confronted in Scotland's constitutional debate.

This is not to dismiss the value of analysing short term challenges and problems and the policy response that different constitutional states might facilitate, as these immediate and relatively transitory challenges are, of course, one important and tangible test of any new constitutional state. But they are seriously limited as a test of a long term constitutional change.

There is an important, additional point here: we should pay close attention to any adjustment or transition process from one economic system to another (which is, of course, a separate consideration from any short term and temporary economic challenge, such as a recession or banking crisis, that happens to be important at a particular point in time). If adjustment is anticipated to take years or even decades, then most people would probably seek long term benefits that are more substantive and more certain. So, the analysis of the long term outcomes is again a key part of this debate.

The Tests look at how a more structured approach to the assessment of the various constitutional proposals is possible, with a particular emphasis on the long term value of the proposals: that is, over the time horizon that is most relevant to such a fundamental political transformation. This approach focuses only on the economic dimension of the constitutional propositions: it specifically takes no account of an array of other factors, whether political or social in nature, for example. There are, of course, many instances of different peoples legitimately choosing self-determination and an independence model irrespective of any economic arguments that were advanced at the time.

The *Six Tests* crystallise the key challenges for Scotland in its economic analysis of potential constitutional change. They are designed to answer the questions:

- how does any proposed constitutional arrangement bear up when evaluated against these *Tests*?
- is the long-term economic sustainability of the Scottish economy secured under this constitutional arrangement, given the exceptional uncertainty and risks that most certainly exist when our time horizon is many decades?
- what are the relative strengths and vulnerabilities of the different proposals?

Six Tests to evaluate proposals for constitutional change.

1. *New Opportunities:*

- Would the proposed political and economic structure bring new economic, social and environmental opportunities that do not currently exist?

2. *Cyclical compatibility and stability:*

- Are the business cycles and economic structures of the partners in any proposed monetary union compatible? How would the implications of incompatibility and the need for cyclical stabilisation be managed?

3. *Long term competitiveness:*

- How would Scotland promote competitiveness and, if need be, restore competitiveness?

4. *Resilience and managing global shocks:*

- Are there well developed means to manage significant global shocks?

5. *Risk management and uncertainty:*

- Are the other primary risks and uncertainties of the proposal identified, and are there mechanisms through which they could be effectively managed?

6. *Summary Test for proposals for constitutional change:*

- Is the proposal fundamentally economically and financially stable?
- Would the proposal enhance the capacity to promote the primary objectives of economic policy?

Source: Goudie (2013)

Tests such as these are - correctly - open to the criticism that they tend to be too mechanistic (which is true) and don't capture all the points (which is true, too, although they should capture the primary points, where agreement on these is possible). On the other hand, they arguably bring some rigour to what can otherwise degenerate into a very confusing and unstructured analysis. This may suit some, of course, as it can helpfully obscure the failure to address key issues.

III Concluding thoughts.

While the Referendum campaign inevitably will take on an intensely political character as the vote approaches, the key economic challenges of *all* the constitutional options that may emerge arguably need to remain sharply defined and be to the fore of the debate.

Realism about what can and cannot be answered with any precision at this time is equally critical. Little is ultimately to be gained from cavalier assertions lacking any real basis in evidence from either Scotland

or from the experience of other economies. In fact, the answers to many key questions are simply unknown at this time. They may depend on institutional structures yet to be negotiated and whose precise form is therefore unknowable. They may depend on the impact of policy choices – facilitated by constitutional change that brings with it new powers, either within an independent Scotland or with enhanced powers within the UK – where our knowledge is too soft to provide the clarity that we seek. Evidence may be lacking or only exist for economies other than Scotland, or new powers and new policy simply create an economic system for which we have no history of how individual economic agents and businesses might respond. This is not a failing of analysis: it is a reality about any non-marginal economic policy change that creates a new set of incentives and behaviours that an economy has never seen before. We can – and should – offer the insights that theory and other economies can provide, but we cannot know with certainty.

Thus, there is a simple reality here. Choices in the Referendum – and, indeed, choices post-Referendum about the precise detail and form that enhanced devolution or independence might actually take – cannot be founded on hard fact and hard evidence, as we might wish.

Indeed, one striking conclusion would appear to be the importance of acknowledging openly the intractability of some challenges and the obvious risks and, instead, providing a focus on the management of risk and uncertainty, much as the private sector has done for years. Risk and uncertainty are not *per se* reasons to forego an opportunity, but a motivation for contingency planning.

While policy impacts will remain highly uncertain, this does highlight the critical nature of the post-Referendum phase and the negotiations that will follow around the institutional structures and multilateral agreements that will be necessitated by any constitutional change.

The ultimate challenge is this: *given our incomplete understanding and obvious ignorance of the precise form of any constitutional arrangement and the impact of new economic powers that it would bring, do the uncertain net benefits of greater economic powers appear to sufficiently outweigh the uncertain net benefits of the current powers? Or is the fact of greater self-determination - necessarily, constrained within an integrated global economy - with all its uncertainties, a strong enough motivation?*

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